Executive Compensation in Public Companies: Are You Ready for 2013?

By Michael F. Corrente

As 2013 gets into full swing, public companies should be reviewing their executive compensation arrangements and, more specifically, incentive compensation — such as bonus plans, stock options, stock appreciation rights (SARs), restricted stock and restricted stock units (RSUs).

Generally, these incentives are designed as "qualified performance-based compensation," which is exempt from the $1 million deduction limit on compensation paid to top executives. To ensure that incentives qualify for the exemption, however, your company must meet several strict requirements. For the 2013 tax year, many of these requirements must be satisfied early in 2013.

Also, under a recent IRS ruling, if you use restricted stock or RSUs, you may need to modify eligibility requirements for dividends or dividend equivalents to ensure that they qualify for the exemption.

Applying the $1 Million Limit

Ordinarily, companies are entitled to deduct wages and other compensation as a business expense. But Internal Revenue Code (IRC) Sec. 162(m), as amended, limits a public company's deduction to $1 million for compensation paid to a "covered employee." Under IRS rules, covered employees include the CEO and the next three most highly paid officers other than the CFO (who isn't considered a covered employee).

Certain types of compensation don't count toward the $1 million limit, however. These include payments to or from qualified retirement plans (such as 401(k)s), commissions, certain benefits excluded from gross income and, most significant, qualified performance-based compensation.

Qualifying for the Exemption

To ensure that incentive compensation is exempt from the $1 million limit, your company must satisfy the following requirements:

- The compensation must be paid *solely* on account of pre-established, objective performance goals. An arrangement won't be disqualified, however, merely because compensation is also payable on account of death, disability, or a change in company ownership or control.

- Goals must be established by a compensation committee consisting of two or more "outside directors."

- The compensation committee must establish goals in writing within 90 days after the performance period begins (by March 31 for the 2013 calendar year) or, if sooner, before 25% of the performance period has elapsed (for example, by Jan. 22 for the first quarter of 2013).

- Achievement of performance goals must be "substantially uncertain" at the time they're established. For example, a bonus based on increasing annual sales by 10% is substantially uncertain. But a bonus calculated as a percentage of sales is not — such a bonus is certain to be paid; it's only the amount that's uncertain.

- The compensation committee must not have discretion to increase compensation after a goal has been attained. It may, however, retain "negative discretion" to reduce or eliminate an award.

- The company must disclose an arrangement's material terms to shareholders, and obtain shareholder approval, *before* compensation is paid. Even when the material terms don't change, shareholder "re-approval" is required every five years if the compensation committee has the power to adjust specific performance targets.

- The compensation committee must certify in writing (through approved committee minutes, for example) that performance goals have been achieved *before* compensation is paid.

Certain equity-based incentives, such as stock options and SARs, need not meet all of these requirements. Rather, they're deemed to be qualified performance-based compensation if they're granted by the compensation committee under a plan that 1) states the maximum number of shares for which options or SARs may be granted to individual employees, and 2) sets the exercise price or base value at or above the stock's grant-date fair market value.

But other equity awards, including discounted stock options, restricted stock and RSUs, must meet *all* of the general requirements listed above to be deemed qualified performance-based compensation.

Year-End Planning Considerations

As you plan for 2013, consider taking the following actions:

Review dividend terms. If your company grants restricted stock or RSUs, review the terms under which dividends or dividend equivalents are paid. A recent IRS ruling — Revenue Ruling 2012-19 — clarifies that, even if restricted stock or RSUs are qualified performance-based compensation, any related dividends or dividend equivalents must separately satisfy the requirements under Section 162(m).

The ruling provides examples involving two public companies, which it describes as Corporation X and Corporation Y. Both companies maintain compensation plans under which employees receive restricted stock or RSUs that vest if certain performance goals are attained.

Under Corporation X's plan, dividends and dividend equivalents otherwise payable during the period from grant through vesting are accumulated and become vested and payable only if the underlying performance goals with respect to the restricted stock and RSUs are met.

Under Corporation Y's plan, on the other hand, these dividends and dividend equivalents are paid regardless of whether the underlying performance goals are met. According to the IRS, the dividends and dividend equivalents paid by Corporation X are qualified performance-based compensation excluded from the $1 million deduction limit. But Corporation Y's dividend and dividend equivalent payments don't qualify and, therefore, count toward the $1 million limit.

To ensure that dividends and dividend equivalents don't trigger unwelcome tax consequences, be sure they're tied to performance goals in the same manner as the underlying restricted stock or RSUs.

Secure shareholder approval. To meet the requirements of Sec. 162(m), you must disclose the material terms of your incentive compensation arrangements and obtain shareholder approval before compensation is paid. Material terms include eligible employees (a general description by title or class will suffice), a description of the business criteria used to establish performance goals, and either a formula for calculating compensation or a statement of the maximum amount an employee can receive.

It isn't necessary to disclose specific performance targets. To build some flexibility into your arrangements, you can simply describe the *types* of business criteria used, such as profits or earnings-per-share. This gives the compensation committee some leeway to adapt specific targets to the company's changing circumstances. If you adopt this strategy, however, you must seek shareholder "re-approval" every five years, regardless of whether the material terms change.

As you review your existing compensation arrangements, check to see whether any are due for re-approval in the coming proxy season.

Consider an umbrella arrangement. As noted above, qualified performance-based compensation must be based on an objective standard or formula. The compensation committee can't have the discretion to increase an award, but discretionary *reductions* are permissible.

The ability to exercise negative discretion gives the committee some flexibility to adapt incentive compensation in uncertain economic times. Under an umbrella arrangement, the committee establishes an objective formula or standard that sets a ceiling on incentive compensation, while retaining discretion to reduce or eliminate compensation based on subjective criteria.

Evaluate committee independence. All compensation committee members must be "outside directors." Generally, that means individuals who aren't current officers or employees, former employees receiving compensation for past services (other than qualified retirement plan benefits), former officers, or individuals who receive compensation in a capacity other than director.

Now is a good time to evaluate members' qualifications to avoid tainting future compensation decisions.

Assess pre-IPO plans. Sec. 162(m) doesn't apply to compensation paid during a "reliance period" under compensation arrangements in effect before a company went public. Determining the reliance period is tricky, so check with your advisors to see whether any existing arrangements are now subject to the $1 million limit.

Avoid Surprises

Take steps now to ensure that incentive compensation is tax-deductible. Depending on the amount of compensation involved, failure to meet the requirements of Sec. 162(m) can add hundreds of thousands or even millions of dollars to your company's tax bill. If you need help preparing your executive compensation program for 2013, please contact your CBIZ Tofias tax advisor, or we can be reached at TheBottomLine@cbiztofias.com and 888.761.8835.

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